# PROSPECTS AND CHALLENGES OF THE 2004 PENSION REFORM SCHEME IN NIGERIA: SOME LESSONS FROM THE CHILEAN EXPERIENCE

*BY*

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***ABSTRACT***

*Over the years, existing pension schemes in Nigeria were bedeviled by many problems; the most prominent of these problems included the inability to pay pension to retirees as and when due, and the huge pecuniary and non-pecuniary costs associated with the implementation/administration of the schemes which evidently made them unsustainable. This led to the Pension Reform Scheme in the country in 2004. This paper examines the prospects and challenges of the 2004 Pension Reform Scheme, drawing from the Chilean experience. The major prospects of the new pension reform scheme include: increase in liquidity in the economy which is expected to have favorable multiplier effects on the value of interest rate, investment types, availability of funds for organizations and infrastructural development; development and deepening of the Nigerian capital market; and increase in aggregate savings which is expected to pave the way for rapid and sustainable economic growth and reduction in poverty and inequality in the country. The major challenges of the new scheme include: high transition cost, high commissions, that are most likely to be charged by the profit-maximizing Pension Fund Administrators, which would tremendously reduce the percentage of returns on workers' investment; and the possibility of the minimum pension guarantee creating a substantial contingent liability for the government. It is apparent, however, that the prospects of the new pension scheme far outweigh its challenges. Therefore, the paper concludes by advising that efforts should be made by all stakeholders to maximize the prospects of the new scheme and minimize its challenges.*

**Key words: Pension reform, Chilean experience, prospects, challenges, liquidity, Nigeria**

## INTRODUCTION

The attainment of significant improvement in the welfare and standard of living of the people has been identified by experts in development studies as a core objective of development. Indeed, the fundamental reason for the creation of a nation-state is to improve the living conditions of its citizens. This makes development a principal national objective. It has been recognized that poverty in all its ramifications and manifestations is antithetical to development (Seers, 1972; Olopoenia, 1983; Todaro and Smith, 2003). Suffice it to say that poverty has been recognized as a major blemish in developing economies ever since economists began to take interest in the Third World countries.

A major way of enhancing livelihood in a society is by ensuring that workers in the society enjoy an appreciable level of welfare after retirement; such level of welfare should be able to make the workers to be above the poverty line that is defined for the society. A crucial instrument used in achieving the foregoing is pension scheme. Pension may be conceptualized as a regular payment by an employer to a retired employee, usually till the death of the employee; such payment may also be made to the next-of-kin of a pensioner, after the death of the employee, for a given period of time.

The Federal Government of Nigeria has over the years instituted a number of pension schemes for the Nigerian workers in order to guarantee adequate welfare for them in their post-retirement life and in their old age. It could be recalled that in 1961-just about a year after the attainment of political independence in the country-the National Providence Fund (NPF) was established by an Act of Parliament with the broad objective of catering for the pensions and old age security of certain categories of employees in Nigeria. A major pension system in the early post-independence era was the Public Pension System whose guiding policies could be found in the policy paper emanating from the Udoji Commission Reports, the Pension Decree No. 41 of 1972 and the Official Gazette of 1993.

The administration of the National Provident Fund was undertaken by the government and it was treated as a parastatal in the presidency. The scheme was however replaced by the Nigerian Social Insurance and Trust Fund (NSITF) in 1993 through Decree No. 73 of 1993 due to the glaring inadequacies in the former system which included the

* Inadequate contribution which brought about very low retirement benefits;
* Uncorrelated contribution in relation to the various levels of salary structure (N4.00 per employee regardless of the pay level); and
* Inadequate provision of counseling to workers on the ways to productively spend their benefits.

*The views expressed in the paper are those of the Author and do not in any way represent the views or thinking of the University of Ibadan.*

The foregoing pension schemes were bedeviled by series of problems which adversely affected their effective and efficient performances. The Public Pension System has apparently been mostly affected. Indeed, in recent years the scheme had been unable to pay pensions and retirement gratuities to retirees. This was due to high payroll taxes and tax evasion, misallocation of resources, lack of budgetary provision and inefficiency in the management of the system (Olayiwola, 2002). Other reasons included economic reforms which led to the privatization of some government agencies which brought about the reduction of the workforce and hence reduced contribution and increased pension liability.

In 2004, the Federal Government of Nigeria, under President Olusegun Obasanjo, undertook a pension reform through the Pension Reform Act of 2004 due to the various problems that plagued the pension scheme that existed hitherto. The pension scheme that emanated from the Pension Reform Act (2004) is known as Contributory Pension Scheme (CPS) and this replaced the Pay-As-You-Go (PAYG) scheme which was in place before it.

The new pension scheme under the 2004 Pension Reform Act has many prospects and challenges. In looking at these prospects and challenges, there is need to draw some experience from a comparable pension reform scheme that existed before it in another part of the world. In this connection, the Chilean Pension Reform Scheme is most appropriate. Therefore, this paper will rigorously analyze the new pension reform scheme in Nigeria the Contributory Pension Scheme drawing some lessons from the Chilean experience. The next section contains an overview of the 2004 Pension Reform Scheme in Nigeria while section three contains an overview of the Chilean pension system before reform. Section four highlights features of the Chilean pension reform while section five points out experience from the Chilean pension reform scheme. Section six deals with prospects and challenges of the Nigerian pension reform based on the Chilean experience while section seven contains recommendation; and section eight contains some brief concluding remarks.

## 2. OVERVIEW OF THE 2004 PENSION REFORM SCHEME IN NIGERIA

The inadequacy of the Defined Benefit Pension Scheme also referred to as the Pay-As-You-Go (PAYG) Pension Scheme made the Federal Government of Nigeria to embark on a Contributory Pension Reform Scheme through the 2004 Pension Reform Act that tends to unify the features of the public service with those of the private sector in terms of rate of contribution to benefits, key players and regulation. Before the 2004 Pension Reform Act was passed into law, the pension liability of the Federal Government of Nigeria was put at about three trillion naira (ARM, 2004). This value constituted a huge proportion of the average annual budget of Nigeria in recent times.

The 2004 Pension Reform Scheme in Nigeria which has replaced the Defined Benefit Pension Scheme is well encapsulated in the 2004 Pension Reform Act (FGN, 2004). The objectives of the 2004 Pension Reform Scheme include the following: (a)to ensure that every person who worked in either the Public Service of the Federation, Federal Capital Territory or private sector receives his retirement benefits as and when due;(b)to assist improvident individuals by ensuring that they save in order to cater for their livelihood during old age; and (c) to establish a uniform set of rules, regulations and standards for the administration and payments of retirement benefits for the Public Service of the Federation, Federal Capital Territory and the private sector.

Under the 2004 Pension Reform Scheme, no employee is entitled to make any withdrawal from his retirement savings account before attaining the age of 50 years. However, any employee that is retired before the age of 50 years on the advice of a suitably qualified physician or a properly constituted medical board certifying that the employee is no longer mentally or physically capable of carrying out the functions of his office, or any employee that is retired before the age of 50 years due to this total or permanent disability either of the mind or of the body, or any employee that retires before the age of 50 years in accordance with the terms and conditions of his employment shall be entitled to make withdrawals in accordance with the following provisions:

(a) a holder of a retirement savings account upon retirement or attaining the age of 50 years shall be entitled to utilize the balance standing to the credit of his retirement savings account for the following benefits:

   (i) programmed monthly or quarterly withdrawals on the basis of an expected life span;

   (ii) annuity for life purchased from a life insurance company licensed by the National Insurance Commission with monthly or quarterly payments; and

   (iii) a lump sum of the balance standing in the credit of his retirement savings account provided that the amount left after that lump sum withdrawal shall be sufficient to procure an annuity or fund programmed withdrawals that will produce an amount not less than 50 per cent of his annual remuneration as at the date of his retirement.

(b) where an employee retires before the age of 50 years in accordance with the terms and conditions of his employment, the employee may, on request, withdraw a lump sum of money not more than 25 per cent of the amount standing in the credit of the retirement savings account provided that such withdrawals shall only be made after six months of such retirement and that the retired employee does not secure another employment.

The 2004 Pension Reform Scheme in Nigeria also has the following provisions:

(i) Where an employee dies, his entitlements under the life

insurance policy maintained in favor of the employee for a minimum of three times the annual total emolument of the employee shall be paid to his retirement savings account. The Pension Fund Administrator (PFA) shall apply the amount paid in favor of the beneficiary under a will or the spouse and children of the deceased or, in the absence of the spouse and children, to the recorded next-of-kin or any person designated by him during his life time or, in the absence of such designation, to any person appointed by the Probate Registry as the administrator of the estate of the deceased.

(ii) Where an employee is duly declared missing he will be presumed to have died and the provisions in (i) above shall apply.

(iii) Any amount payable as a retirement benefit shall not be taxable. However, any voluntary contribution made by an employee in addition to the total contributions made by the employee and his employer shall be subject to taxation at the point of withdrawal where the withdrawal is made before the end of 5 years from the date the voluntary contribution was made.

(iv) Any employee who at the commencement of the 2004 Pension Reform Scheme is entitled to retirement benefits under any pension scheme existing before the commencement of the 2004 Pension Reform Act but has 3 or fewer years to retire shall be exempted from the scheme.

With regard to rate of contribution to the scheme, the 2004 Pension Reform Act stipulated as follows:

(a) In the case of the Public Service of the Federation and the Federal Capital Territory, a minimum of 7.5 per cent should be contributed by the employee; also, a minimum of 7.5 per cent should be contributed by the employer.

(b) In the case of the Military, a minimum of 2.5 per cent should be contributed by the employee and a minimum of 12.5 per cent should be contributed by the employer.

(c) In other cases, a minimum of 7.5 per cent should be contributed by the employee; also, a minimum of 7.5 per cent should be contributed by the employer.

(d) Not withstanding the foregoing, an employer may agree or elect to bear the full burden of the scheme provided that in such a case the employer's contribution shall not be less than 15 per cent of the monthly emoluments of the employee (FGN, 2004).

In addition to the foregoing, the employer shall maintain a life insurance in favor of the retirement savings account in the employee's name with a Pension Fund Administrator (PFA) of the employee's choice. The Pension Fund Administrator, who is to be strictly regulated, would be allowed to invest in government and corporate bonds, treasury bills, debentures, redeemable preference shares issued by corporate entities, ordinary shares of companies listed on the stock exchange, real estate and unit-linked investment schemes. The Pension Fund Administrator is required to maintain accounts on all pension transactions and to provide up-to-date information of its investment strategies. It is also responsible for all calculations and payments of retirement benefits. The Pension Fund Administrator, apart from maintaining a statutory reserve fund from which it will meet claims for which it may be liable as determined by a Pension Fund Custodian (PFC), shall however hold no pension fund asset or keep such with a Pension Fund Custodian in which it has business interest or shares. Every Pension Fund Administrator is required to ensure that pension funds are managed and invested according to the provision of the 2004 Pension Reform Act.

The Pension Fund Custodian, which has to be a licensed financial institution with a very strong footing and a clean track record, is to hold pension funds and assets in safe custody on trust for the employees and the pension scheme's beneficiaries and also to settle transactions on Pension Fund Administrators' behalf. Indeed, all Pension Fund Custodians are required to give regular reports to the National Pension Commission on the activities of the various Pension Fund Administrators. The Pension Fund Custodians are also required to receive all pension contributions and notify the appropriate Pension Fund Administrators of such receipts within 24 hours. To ensure the safety of contributions, a Pension Fund Custodian is required to issue guarantee for the pension funds and assets held by it to the appropriate Pension Fund Administrators. The National Pension Commission is the regulatory authority and is charged with the responsibility of formulating, directing and overseeing the overall policy on pension matters in Nigeria. The body is made up of representatives from both the public and private sectors.

The 2004 Pension Reform Scheme makes provision for the issuance of Federal Government retirement bond to employees in the public service that are currently in pension schemes that are not funded. The bond will be redeemed when the affected employees retire and the amount at redemption will be added to the retirement savings accounts of the beneficiaries. To make this possible, the Federal Government will pay an amount equal to 5 per cent of the total monthly wage bill payable to the workers (in the Federal Public Service) into the Retirement Benefits Bond Redemption Funds. Payments shall however cease after all the retirement benefit bonds issued have been redeemed. In the private sector, the transitional arrangement is such that the benefits will be computed and paid as per the condition of service prior to the commencement of the 2004 Pension Reform Act and the amount will be transferred to the retirement savings account of each employee maintained with the Pension Fund Administrator of his choice.

## 3. OVERVIEW OF THE CHILEAN PENSION SYSTEM BEFORE REFORM

Now coming to the Chilean Pension System and its reform, it is worthwhile to state here that the Chilean Pension Reform - which was initiated in late 1980 and implemented in early 1981 - was part of a series of policy initiatives in Chile in the 1970s and 1980s. It could be recalled that in 1920, Chile adopted a social security system aimed at providing retirement income for the elderly as well as other benefits. In the early years following this time, contribution by active workers exceeded payments to retirees. Thus the original system was not purely pay-as-you-go. Instead surplus was expected to help in meeting increasing obligations as the system matured and the accumulated funds were purely managed. In the 1970s, however, the government raised benefits quickly and the system's assets were gone thus it became a pure pay-as-you-go system.

Non uniformity was one of the difficulties of the original pension system in Chile which had over 180 different regimes. As a result, total contribution by the employers and employees in 1973, for instance, varied between 16 per cent and 26 per cent of wages, depending on the type of occupation (Rodriguez, 1999). These differences created large differences in retirement benefits in which some workers could retire with large pension benefits at the age of 42 years while many blue collar workers could not qualify for retirement benefit until the age of 65 years.

Chile's traditional retirement system also suffered from shrinking number of contributors. For instance, in 1955 the system had 12 active contributors per retiree but in 1979 it had only 2.5 contributors per retiree (Rodriguez, 2001). By 1980, the system was running a deficit equal to 2.7 per cent of the Chilean Gross Domestic Product and the discounted present value of the system's contingent liabilities exceeded the Gross Domestic Product (Sebastian, 1998). The deficit put increasing stress on the existing system and heightened the pressure/demand for the pension reform that formally kicked off in 1981.

## 4. FEATURES OF THE CHILEAN PENSION REFORM

The reform of the Chilean pension system - implemented in early 1981 - replaced the hitherto existing pay-as-you-go regime with a fully-funded pension system based on individual capital account, managed by private companies(or Pension Fund Administrators) known as Administradoras de Fondos de Pensiones (AFPs). To reduce political opposition at the time of the reform and to increase interest in the new system, contribution rates were set at a level low enough to increase net “take-home” pay. This was financed by increase in minimum retirement age. On average, workers that opted for the new regime obtained 11 per cent effective increase in net wages (Ruiz-Tagle, 1998). Also, in order to recognize workers' past contributions to the old system, the government issued special bonds - known as “Recognition Bonds” - and deposited them in the transferring workers' individual capital accounts. The bonds were paid in full upon retirement. These bonds provided the link between the contributions to the old system and the new retirement funds (Ruiz-Tagle, 1998).

The Chilean Pension Reform Scheme (which effectively began in 1981) was encapsulated in the Chile's Social Security Reform Act of 1980. The Act allowed current workers to opt out of the hitherto existing government - operated pension system financed by payroll taxation - and start contribution to a personal retirement account, under the new pension reform scheme. Under the new scheme, what determines workers retirement benefits are the amounts of money accumulated in their personal retirement savings accounts during their working years. The workers and their employers do not pay payroll taxes; also the workers do not collect government financed benefits rather 10 per cent of their pre-tax wages is deposited into their personal accounts monthly. Workers may contribute up to an additional 10 per cent a month of their pre-tax wages. The invested amount grows on a tax-free basis, and the workers pay tax on the money only when they withdraw it at retirement.

Upon retirement, workers may choose from the following three options, according to the Pension Reform Act: (a) purchase a family annuity from a life insurance company indexed to inflation; (b) leave their funds in their personal retirement savings accounts and make monthly withdrawals, subject to limits on life expectancy (if a worker dies, the remaining funds form a part of his estate); or (c) any combination of (a) and (b). In all cases, if the amount exceeds the amount needed to provide a monthly benefit equal to 70 per cent of the workers' most recent wages then the workers can withdraw the surplus as a lump sum.

A worker who has reached retirement age and has contributed for 20 years but whose accumulated fund is not enough to provide a minimum pension as defined by the Pension Act will receive the amount from the government once the fund in the personal retirement savings account has been depleted. Workers may choose any one of several competing Pension Fund Administrators [known as Administradoras de Fondos de Pensiones (AFPs)] to manage their accounts. These companies are subject to strict supervision by a government agency called the Superintendencia de Administradoras de Fondos de Pensiones (SAFP). This body is equivalent to the Nigerian version of the National Pension Commission. SAFP reports to the government through the Ministry of Labor and Social Security. The major functions of the SAFP include to approve the creation of new AFPs, to regulate their operations, to ensure that the AFPs comply with minimum capital and cash requirements, to provide policy advice to the government, to interpret legislations and regulations, to provide general rules for AFP administration, to levy fines and to oversee the dissolution of AFPs when applicable.

The provisions for safety as contained in the Pension Reform Act specify that AFPs should invest only in approved assets with diversified portfolios while the profitability provisions allow the AFPs to seek the highest returns with the approved parameters (Vittas and Iglesias, 1992). The regulations may be

summarized as the separation of assets, "one fund" and "one account" rules, and rules governing non-discrimination, solvency, investment, trading and valuation, minimum profitability and information disclosure (Vittas, 1996).

Each worker receives a statement from his Pension Fund Administrator every three months and he can keep of the retirement capital at any moment. Workers with enough retirement savings in their accounts to buy sufficient annuities, which amount to 50 per cent of their average salary, as long as it is 20 per cent higher than the minimum pension, can stop contributing and begin to withdraw their money. But there is no obligation to stop working at any age (before the retirement age) and there is also no obligation to continue to work or to save for retirement once a worker has met sufficient benefit threshold.

Due to the fact that the personal retirement savings accounts are tied to the workers and not to the employers, workers can take their accounts with them when they move to other jobs thus keeping the labor market flexible. Each year, every Pension Fund Administrator is required to guarantee that its return is not lower than the prescribed minimum as contained in the Pension Reform Act. If the return of a Pension Fund Administrator is higher than the specified limit as contained in the Act, the excess is placed in a profitability fluctuating reserve. Funds will be drawn from this reserve whenever the return of the Pension Fund Administrator falls below the required minimum. If a Pension Fund Administrator does not have enough funds in the profitability reserve, the remaining required fund will be drawn from a cash reserve which is equivalent to 1 per cent of total assets under management. And if the cash reserve does not have enough funds then the government will make up the difference and the Pension Fund Administrator will be liquidated.

It is instructive to note at the point that the Chilean Pension Reform Scheme and the Nigerian Pension Reform Scheme have common characteristics. Table 1 below shows the basic characteristics of the Chilean and the Nigerian Pension Reform Schemes.

**Table 1: Basic Characteristics of the Chilean and the Nigerian Pension Schemes**

| Serial No. | Aspects of Reform | Chile | Nigeria |
|---|---|---|---|
| 1. | Inception Date | 1981 | 2004 |
| 2. | Mandatory/Optional | Mandatory | Mandatory |
| 3. | Parallel Public System | No | No |
| 4. | Contribution Rate as a Percentage of Salary | 10per cent | 7.5per cent |
| 5. | Voluntary Contribution | Yes | Yes |
| 6. | Government Contribution | No | Yes (7.5per cent) |
| 7. | Additional Savings | Yes | Yes |
| 8. | Fixed Commission | Yes | Not yet determined |
| 9. | Variable Commission on Contributions | Yes | Yes |
| 10. | Discount Allowed | No | No |
| 11. | Old Age Pension | Yes | Yes |
| 12. | Disability and Survivors Pension | Yes | Yes |
| 13. | Early Retirement | Yes | Yes(50 years) |
| 14. | Number of Funds per Pension Fund Administrator | 1 | Not yet determined |

| Serial No. | Aspects of Reform | Chile | Nigeria |
|---|---|---|---|
| 15. | Investment Limits | Yes | Not yet determined |
| 16. | Guaranteed Minimum Return | Yes | Not defined |
| 17. | Profitability Fluctuation Reserve | Yes | - |
| 18. | Legal Reserve | Yes | - |
| 19. | Number of Pension Fund Administrators | 8(as at May,1999) | 13(as at August,2005) |
| 20. | Number of Contributors | 2,619,616(as at December,1998) | Not yet specific |
| 21. | Asset Under Management(AUM) | $34.1billion(as at May,1999) | - |
| 22. | Rate of Return(real annual average,1981-1998) | 11per cent | - |
| 23. | AUM/Gross Domestic Product | 42per cent approximately | - |
| 24. | Statutory Reserve | - | 12.5per cent |

*Sources: Rodriguez (1999); FGN (2004); various Nigerian newspapers*

## 5. EXPERIENCE FROM THE CHILEAN PENSION REFORM SCHEME

The substitution of the pay-as-you-go pension scheme with a fully-funded arrangement has been described as the optimal therapy that will permanently solve the problems associated with the hitherto existing pension system in Nigeria (ARM, 2004). The fully-funded pension scheme can be assessed by investigating the performance of similar schemes embarked upon by some other countries. And Chile is apparently the most appropriate country for it is the first country in the world to introduce a fully-funded pension scheme and the country's pension reform scheme is similar to that of Nigeria in many ways. The Chilean Pension Reform Scheme, which the Nigerian Pension Reform Scheme took after, has been in place long enough to provide reasonable evidence of benefits and problems associated with it. With this, the chances of Nigeria drawing some lessons from the Chilean system could be seen. We will now draw experience from the Chilean Pension Reform Scheme along the following lines of thought.

### 5.1 Social Security Coverage

The social security coverage is the extent to which the population of the workers participates in the pension scheme. It also shows the level of acceptance among the workers especially against the backdrop of the room for choice between the former system (the pay-as-you-go system) and the new system (the fully funded pension scheme). Table 2 shows the development of the social security coverage in Chile between 1980 and 2003.

Table 2 reveals three basic facts about the social security coverage in Chile namely: (a) from the inception of the pension reform in 1981, the percentage of workers covered by the pay-as-you-go system decreased sharply between 1980 and 1982, from 51.6 per cent to 16.7 per cent, and thereafter it decreased almost consistently, reaching 2.8 per cent in 2003. This percentage is expected to gradually reduce to zero as the workers covered by the old scheme finally retire from service; (b) the percentage of workers under the pension reform scheme increased sharply from zero in 1980 to 38 per cent in 1982 and then it increased almost consistently and got to 63.8 per cent in 2003; and (c) the overall coverage of pension increased from 51.6 per cent in 1980 to 66.6 per cent in 2003. This increase in coverage was due to the fact that the pension reform scheme is more economical than the pay-as-you-go system with the gross wages estimated as 12.3 per cent as opposed to 19 per cent under the pay-as-you-go system (Rodgriguez, 1999).

**Table 2: Development of Social Security Coverage in Chile (as percentage of workers)**

| Year | Workers under PAYG (per cent) | Workers under AFPs (per cent) | Total |
|---|---|---|---|
| 1980 | 51.6 | - | 51.6 |
| 1981 | 30.6 | 21.4 | 52 |
| 1982 | 16.7 | 36 | 52.7 |
| 1983 | 14.9 | 38.3 | 53.2 |
| 1984 | 13.9 | 41.8 | 55.7 |
| 1985 | 13 | 44.1 | 57.1 |
| 1986 | 11.4 | 45.9 | 57.3 |
| 1987 | 10.9 | 50.6 | 61.5 |
| 1988 | 9.8 | 50.6 | 60.4 |
| 1989 | 8.7 | 50.8 | 59.5 |
| 1990 | 7.8 | 50.6 | 58.4 |
| 1991 | 7.6 | 53.7 | 61.3 |
| 1992 | 6.9 | 55.3 | 62.2 |
| 1993 | 6 | 54.7 | 60.7 |
| 1994 | 5.5 | 56.2 | 61.7 |
| 1995 | 5.5 | 57.2 | 62.7 |
| 1996 | 4.9 | 58.9 | 63.8 |
| 1997 | 4.3 | 61.3 | 65.6 |
| 1998 | 4.1 | 58.0 | 62.1 |
| 1999 | 3.8 | 60.4 | 64.2 |
| 2000 | 3.8 | 59.4 | 63.2 |
| 2001 | 3.3 | 63 | 66.3 |
| 2002 | 3.1 | 61.9 | 65 |
| 2003 | 2.8 | 63.8 | 66.6 |

*Source: The Chilean AFP Association*

### 5.2 Cost of the Pension Reform Scheme

To put the cost of the pension reform scheme into proper perspective it is necessary to compare the cost with costs of some other institutions that manage savings. In the Chilean pension system the administrative cost is usually obtained by dividing the commission fee - which ranges between 2.49 per cent and 2.95 per cent of taxable wages - by the total contribution (10 per cent plus the commission). The commission should adequately cater for the workers' disability and survivorship insurance. If the commission charged by the Pension Fund Administrators is measured as a percentage of the managed funds it amounts to 0.63 per cent per year on the average (The Chilean AFP Association, 2004). This is substantially lower than those of other fund managers like the USA Mutual Funds with 1.38 per cent, 401 k USA with 1.46 per cent and Chilean Mutual Funds with a commission fee of 2.3 per cent per year on the average.

### 5.3 Pension Fund Assets

The Chilean Pension Reform Scheme evidently brought about rapid growth in pension fund assets. For instance, between 1981 and 1998, pension fund assets as percentage of GDP grew tremendously, from 0.9 per cent in 1981 to 58.6 per cent in 2003 (see table 3). The immense growth in pension assets (following the implementation of the pension reform scheme) has contributed greatly to the development and the deepening of the Chilean capital market which is by far the most advanced in Latin America in recent times; it has also contributed greatly to the development of the risk rating industry in Chile.

**Table 3: Cumulative Value and Rates of Return on Chilean Pension Fund Assets: 1981-2003**

| Year | Pension Fund Assets under Management(value in millions of current pesos) | Percentage of GDP | Returns on Fund Assets (average yearly real return in per cent) |
|---|---|---|---|
| 1981 | 11,695 | 0.9 | 12.8 |
| 1982 | 44,495 | 3.7 | 28.5 |
| 1983 | 99,474 | 6.5 | 21.3 |
| 1984 | 159,576 | 8.4 | 3.6 |
| 1985 | 281,807 | 10.3 | 13.4 |
| 1986 | 433,377 | 12.7 | 12.3 |
| 1987 | 644,728 | 14.1 | 5.4 |
| 1988 | 885,875 | 14.7 | 6.5 |
| 1989 | 1,329,268 | 17.5 | 6.9 |
| 1990 | 2,244,481 | 23.3 | 15.6 |
| 1991 | 3,769,243 | 29.7 | 29.7 |
| 1992 | 4,736,462 | 29.4 | 3.0 |
| 1993 | 6,830,788 | 35.4 | 16.2 |
| 1994 | 8,983,563 | 38.8 | 18.2 |
| 1995 | 10,230,990 | 36.1 | -2.5 |
| 1996 | 11,555,632 | 37 | 3.5 |
| 1997 | 13,405,826 | 38.6 | 4.7 |
| 1998 | 14,552,547 | 39.8 | -1.1 |
| 1999 | 18,093,003 | 48.7 | 16.3 |
| 2000 | 20,343,371 | 50.1 | 4.4 |
| 2001 | 22,955,974 | 52.8 | 6.7 |
| 2002 | 25,227,058 | 54.4 | 3 |
| 2003 | 29,176,611 | 58.6 | 10.5 |

*Source: Arenas de Mesa (2005)*

The returns on pension fund assets have been highly significant in Chile since the pension reform scheme started. The returns ranged from 3.6 per cent and 29.7 per cent between 1984 and 1991 and it was 3 per cent in 1992 and 10.5 per cent in 2003 (see table 3). It is worthwhile to note that the pension fund assets experienced negative returns twice between 1981 and 2003 - in 1995 (when it was -2.5 per cent) and in 1998 (when it was -1.1 per cent). The negative return of -2.5 per cent experienced in 1995 was due to the Mexican pesso crisis; and the negative return of -1.1 per cent experienced in 1998 was attributable to the effects of the Asian crises, lower commodity prices and an economic down turn (Rodriguez, 1999).

### 5.4 Financial Deepening of the Capital Market in Chile

The implication of the pension reform scheme in Chile can be investigated through the structure and development of the capital market. Table 4 shows the structure and development of the Chilean capital market from 1980 to 2000. The data available are on: (a) asset turn over, taking into consideration stock, financial intermediation and fixed income securities;(b) stock market asset valuation;( c) institutional investors funds involving insurance company reserves, pension funds, mutual funds and foreign investment funds;(c)corporate aggregate; and (d)monetary aggregate (M7-M1 or Index of financial debt).

The development phases in the Chilean capital market, based on table 4, can be grouped into three: 1980 - 1985, 1986-1995 and 1996-2000. In the period 1980-1985, stock transactions decreased markedly both as a percentage of GDP and in US dollar terms; this was a direct consequence of the economic and financial crisis experienced in Chile between 1982 and 1983, whose effect extended until 1985 (Cifuentes et al, 2002). The development of the pension reform scheme led to the investment of significant proportion of the country's portfolio in fixed income securities; it also led to significant growth of insurance company reserves (Cifuentes et al, 2002). In the period 1986-1995, the Chilean

**Table 4: Structure and Development of Capital Market in Chile: 1980-2000**
**(as a percentage of GDP of each year)**

| Year | Asset Turnover | | | Stock Market Valuation | Institutional Investors | | | | Corporate | M7-M1(indicator of financial depth) |
|---|---|---|---|---|---|---|---|---|---|---|
| | Stock | Financial Intermediation | Fixed Income Security | | Insurance Company Reserves | Pension Funds | Mutual Funds | Foreign Investment Funds | | |
| 1980 | 2.41 | 0.25 | 3.27 | 41.87 | 2.02 | - | 2.68 | - | 0.19 | - |
| 1981 | 1.39 | 0.55 | 8.54 | 26.58 | 1.91 | 1.16 | 2.62 | - | 0.37 | 27.72 |
| 1982 | 0.56 | 3.29 | 10.42 | 21.55 | 2.32 | 3.50 | 2.44 | - | 1.66 | 32.22 |
| 1983 | 0.31 | 5.74 | 3.24 | 13.08 | 2.59 | 6.43 | 0.55 | - | 1.91 | 31.06 |
| 1984 | 0.21 | 4.42 | 2.90 | 11.41 | 2.91 | 7.58 | 0.49 | - | 1.37 | 31.05 |
| 1985 | 0.32 | 10.61 | 9.23 | 13.08 | 3.41 | 10.63 | 0.76 | - | 1.53 | 37.94 |
| 1986 | 1.67 | 24.26 | 16.54 | 22.90 | 3.89 | 12.67 | 1.21 | - | 0.85 | 39.62 |
| 1987 | 2.43 | 26.24 | 24.67 | 25.43 | 4.44 | 14.20 | 1.43 | - | 1.37 | 43.03 |
| 1988 | 2.54 | 34.13 | 40.14 | 27.47 | 4.39 | 14.97 | 1.39 | - | 2.01 | 42.08 |
| 1989 | 2.98 | 42.48 | 32.67 | 33.16 | 5.15 | 17.65 | 1.29 | 0.38 | 3.37 | 49.52 |
| 1990 | 2.93 | 45.5 | 17.28 | 43.73 | 6.71 | 24.21 | 1.58 | 1.65 | 4.57 | 58.94 |
| 1991 | 5.52 | 35.15 | 27.09 | 81.64 | 7.89 | 31.37 | 2.64 | 2.97 | 5.59 | 61.23 |
| 1992 | 4.75 | 53.17 | 39.19 | 69.60 | 8.22 | 30.56 | 2.32 | 2.69 | 4.87 | 61.23 |
| 1993 | 6.13 | 55.86 | 61.30 | 73.15 | 9.65 | 37.02 | 2.86 | 3.63 | 4.80 | 62.62 |
| 1994 | 10.06 | 89.02 | 63.26 | 124.78 | 8.65 | 40.99 | 3.36 | 3.85 | 4.52 | 62.64 |
| 1995 | 17.51 | 128.47 | 95.01 | 111.99 | 9.80 | 39.88 | 3.98 | 3.06 | 3.48 | 65.35 |
| 1996 | 11.67 | 118.96 | 167.28 | 98.99 | 11.45 | 40.88 | 4.21 | 2.12 | 2.46 | 72.82 |
| 1997 | 10.17 | 121.23 | 193.68 | 100.08 | 12.40 | 42.47 | 5.29 | 1.93 | 2.98 | 79.15 |
| 1998 | 6.21 | 127.40 | 273.23 | 72.99 | 13.41 | 43.27 | 3.89 | 1.20 | 3.74 | 81.32 |
| 1999 | 10.17 | 72.87 | 199.09 | 105.01 | 15.16 | 52.56 | 5.59 | 1.85 | 5.33 | 87.13 |
| 2000 | 8.92 | 64.47 | 191.83 | 91.74 | 16.74 | 53.85 | 8.77 | 0.98 | 5.33 | - |

*Source: Cifuentes et al(2002)*

capital market advanced remarkably in size, depth and liquidity. Stock transactions grew faster than GDP, fixed income transaction and financial intermediation (commercial papers and other short term securities) grew remarkably well, stock market asset valuation increased tremendously and asset values grew greatly at an average rate of 56 per cent. The growth of asset values in the period under reference was due the growth in the volume of funds managed by institutional investors and foreign capital inflows. Furthermore, in the period 1986-1995, pension funds increased their share of GDP from about 11 per cent in 1985 to about 40 per cent in 1995 while insurance company reserves rose from about 3 per cent of GDP in 1986 to about 10 per cent of GDP in 1995. Also, mutual funds, foreign investment funds and corporate bonds increased their shares of GDP stupendously in the period under reference. And monetary aggregate (M7-M1) - which is the most comprehensive indicator of financial depth-increased enormously from about 38 per cent of GDP in 1985 to about 65 per cent of GDP in 1995.

In the period 1996-2000, stock market transactions declined almost throughout the period, financial intermediation increased from 1996 to 1998 but dropped in 1999 and 2000; pension funds continued to increase their share of GDP throughout the period; insurance company reserves also increased throughout the period; mutual funds increased their share almost throughout the period; corporate bonds issued in domestic markets decreased from about 3.5 per cent in 1995 to 2.46 per cent in 1996 and then it rose to 5.33 per cent in 1999 and remained so in 2000; foreign investment reduced from 3.06 per cent in 1995 to 2.12 per cent in 1996 and it fell to less than 1 per cent in 2000; and the index of financial depth - the monetary aggregate (M7 M1) - shows consistent growth throughout this period thus suggesting that the total pool of savings increased systematically within the period under reference.

To reconcile the continued growth in savings with the significant reduction in stock and bond transactions as well as in stock valuation since 1995, five reasons were given by Cifuentes et al (2002) namely: (a) application of taxes on some secondary insurance in 1995 which seriously affected financial integration and dried up liquidity in domestic markets;(b) domestic financial markets are over regulated, particularly in the case of pension funds, which has hampered innovation and creativity and stimulated rent-seeking behaviors; (c) high cost of listing small and medium scale companies on the stock exchange; (d) the domestic stock market is a poor representation of the

economy's GDP especially where some sectors have minimum representation despite being significant sectors of the economy; and (e) increased concentration of the pension industries which has created a virtual monopsony among institutional investors.

### 5.5 Transition Cost

The transition cost of the Chilean Pension Reform Scheme can be broken down into three different parts namely: (a) cost of paying for the retirement benefits of those workers who were already retired when the scheme started and of those workers who chose to remain in the old system; (b) cost of redeeming the recognition bond given to workers who moved from the old system to the new system in acknowledgement of the contribution they had made to the old system; and (c) cost of providing a safety net to the system in the form of welfare pension, funded from general reserve and cost of supplementing pension that do not meet the required legally defined minimum pension.

Table 5 shows fiscal requirement of the Chilean Pension Reform Scheme from 1981 to 1996; the figures are given as percentage of GDP. As shown in the table, the expenditure on pension of workers retired under the old system increased from 1.5 per cent of the GDP in 1981 to a peak of 4.2 per cent of the GDP in 1985 and then gradually reduced to 2.6 per cent of the GDP in 1996. The cost would continue to decline and eventually become zero as the last worker exit from the old system.

**Table 5: Fiscal Requirement of the Chilean Pension Reform Scheme (as percentage of GDP)**

| Year | Recognition Bonds | Expenditure on Pension of Workers Retired under the Old Scheme | Total Fiscal Cost |
|---|---|---|---|
| 1981 | 0.00 | 1.45 | 1.45 |
| 1982 | 0.09 | 1.85 | 1.94 |
| 1983 | 0.17 | 2.36 | 2.53 |
| 1984 | 0.22 | 3.22 | 3.44 |
| 1985 | 0.24 | 4.22 | 4.46 |
| 1986 | 0.33 | 3.94 | 4.27 |
| 1987 | 0.41 | 3.32 | 3.73 |
| 1988 | 0.42 | 3.4 | 3.82 |
| 1989 | 0.41 | 2.55 | 2.96 |
| 1990 | 0.50 | 3.23 | 3.73 |
| 1991 | 0.44 | 3.30 | 3.74 |
| 1992 | 0.49 | 3.10 | 3.59 |
| 1993 | 0.60 | 3.07 | 3.67 |
| 1994 | 0.65 | 2.97 | 3.62 |
| 1995 | 0.67 | 2.77 | 3.44 |
| 1996 | 0.69 | 2.60 | 3.29 |

*Source:Rodriguez(1999)*

The table also shows that recognition bonds increased from zero in 1981 to 0.7 per cent in 1996, though with period of unsteady increase between 1989 and 1992. Given that these bonds would be redeemed when the recipients retire, the cost to the government would gradually increase as transition workers retire and then will eventually disappear. The total fiscal cost increased from 1.5 per cent in 1981 to a peak of 4.5 per cent in 1985; it declined to 3.7 per cent in 1987, increased to 3.8 per cent in 1988, declined to 3.0 per cent in 1989; increased from 1990 to 1991 and then declined to 3.6 per cent in 1992; it increased to 3.7 per cent in 1993 and it then decreased throughout from 1994 to 1996. It is instructive to state here that Chile used the following five methods to finance the transition: (a) new government bonds; (b) sold some state owned enterprises; (c) maintaining a fraction of the old payroll tax as a temporary transition tax which has since ceased; (d) by cutting down government expenditures; and (e) pension privatization and other market reforms (Rodriguez, 1999).

## 6. PROSPECTS AND CHALLENGES OF THE NIGERIAN PENSION REFORM BASED ON THE CHILEAN EXPERIENCE

This section highlights some of the major prospects and challenges of

the 2004 Pension Reform Scheme in Nigeria, drawing from the Chilean experience. Sub-section 6.1 points out some of the major prospects while sub-section 6.2 highlights some of the major challenges of the Nigeria pension reform.

### 6.1 MAJOR PROSPECTS OF THE NIGERIAN PENSION REFORM SCHEME

Based on the Chilean experience some of the major prospects of the 2004 Pension Reform Scheme in Nigeria are stated below:

(a) As the contributions to the pension reform scheme continue it is most likely that there will be a gradual increase in liquidity in the economy. This increase in liquidity will, all other things being equal, expectedly bring about a multiplier effect on the value of interest rate, investment types, availability of funds for organizations, variety of credit facilities and infrastructural development.

(b) With the increase in the rate of savings, interest rates would most likely drop. This will encourage manufacturers and various business organizations to go for loans that have been difficult to get in the past. Financial institutions will also be more willing to consider longer term investments for possible maximum returns. Already, many banks are offering diverse loan packages aimed at boosting advances to customers for investment. Further, as more funds reach investors in the real sector the resultant effects on output, poverty and income inequality would lead to sustainable livelihood for greater number of the population.

(c) It is expected that the pension reform scheme would assist greatly in the development and deepening of the Nigerian capital market. Before the pension fund will gain adequate footing it is expected that the stock market would record higher stock valuations partly because large sums of money available with the Pension Fund Administrators would be chasing the few available stocks in the secondary market. And as the fund grows, companies are expected to assess the capital market for equity and debt to raise cheap money; thus the real sector is most likely to benefit from the pension fund thereby increasing the possibility of new investments and industrial expansion and diversifications. This avalanche could trigger off the participation of other institutional investors in the capital market especially when the entry of these institutions into the market becomes a very strong incentive for stock investment. Currently, the stock market is experiencing over subscription of public offers of stocks in the primary market.

(d) Apart from the 7.5per cent (of workers' emoluments) as contribution by government and the cost of transition from the old pension scheme to the new scheme, the government does not make any other pension payment thus the different tiers of government would then have more money to spend on infrastructural development as well as other developmental projects and programs for the benefit of the people.

(e) The mandatory contributions of workers and their employers would force workers to save on a large scale thus leading to adequate funding of the new pension scheme and hence availability of funds to pay retirement benefits. And the National Pension Commission is expected to act as the watch-dog of the Pension Fund Administrators. The presence of the National Pension Commission will most likely prevent the abuse of workers' funds as was the case in the old pension scheme.

(f) Due to the rules and regulations given out to control the operations of the Pension Fund Administrators, workers' funds are expected to be exposed to minimum investment risk under ideal conditions.

(g) On the part of the workers, the habit of saving is expected to be imbibed gradually and as workers watch their savings and investment grow, it is most likely that they would be encouraged to save more money in excess of the stipulated minimum of 7.5per cent of their emoluments for further investments. This will have tremendous positive impact on the economic growth of Nigeria and on the independence/welfare of the workers. With the anticipated huge pension funds in their accounts workers would become owners of assets that can enhance and sustain their welfare even during old age as is in the case of Chile.

(h) The pension reform scheme in Nigeria also has the prospect of improving corporate governance in the country. Since institutional investors like the Pension Fund Administrators would like to tie their investments to good corporate governance, companies would likely put in their best in the management of their affairs so as to convince the Pension Fund Administrators for more investments.

### 6.2 MAJOR CHALLENGES OF THE NIGERIAN PENSION REFORM SCHEME

Some of the major challenges of the 2004 Pension Reform Scheme in Nigeria, following the Chilean experience are stated below:

(a) The transition cost would constitute a great drain on the purse of the government, especially when workers would consequently begin to pay less tax and government continues to pay at least a contribution of 7.5 per cent of workers' emoluments in addition to 5 per cent of the total monthly wage bill payable to employees in the public service into the Redemption Funds for the redemption of the retirement bond for workers retiring under the old pension scheme. This will impose great financial stress on the fiscal allocation of the government. Also, due to the fact that the government is still

involved in the contribution to the scheme, great commitment and fiscal discipline is needed on the part of the government otherwise the scheme may suffer the same problem that plagued the old pension scheme.

Moreover, given the delay in the take-of of the scheme in terms remitting contributions from PENCOM to Pension Fund Administrators, workers are likely to incur more cost in terms of foregone interest payments on funds not transferred on time to Pension fund administrators. For example, some workers who registered with some Pension Fund Administrators over ten months or more ago are yet to have their accounts credited with the money already contributed. The verification of workers in the new pension scheme is affecting the transfer of fund from PENCOM to Pension fund administrators and this problem needs urgent attention so as enlarge the pool of fund available for investment and hasten the pace of enlisting every eligible worker into the scheme.

(b) Going by the tendency of Nigerian financial institutions to pursue extreme profit maximization to the detriment of their clients, the issue of commission to be charged by the Pension Fund Administrators is most likely to be problematic. Unless the National Pension Commission comes out with a favorable regulation, workers may not be able to have a satisfactory percentage of return on their investment; and excessive regulation is not in the spirit of a deregulated and liberalized economy. Thus, this area is a major challenge to the pension reform scheme.

(c) The issue of non-sustainability of the benefits under the old pension scheme is still a major area of concern. The magnitude of benefits for current pensioners (public sector employees within 3 years of qualifying for benefits) and even the accrued pension rights of current workers moving from the old pension scheme to the new are in principle protected by the Pension Reform Act and cannot be adjusted even though the benefits/rights are recognized as being too generous. The inability to optimally address this issue raises questions about equity and transition costs associated with carrying the two pension systems. The pension reform implies that there will be a reduced level of pension benefits for public sector workers especially those with low incomes relative to their counterparts who retired or will retire under the old scheme or who crossed to the new scheme.

(d) The minimum pension guarantee could create a substantial contingent liability for the government. This is because its redistributive impact will depend on the coverage of the new pension scheme (which is fully funded) with the probability that mostly urban, formal and relatively higher income segments of the labor market will benefit from the scheme. Part of the liability will be the determination of a consistent threshold for various segments of the labor market.

## 7. RECOMMENDATIONS

Having stated some of the major prospects and challenges of the 2004 Pension Reform Scheme in Nigeria, drawing from the Chilean experience, we are constrained to recommend as follows:

(a) Now that the pension reform scheme is still fresh, the participation of the government may be satisfactory but as time goes on, the zeal of the government may drop and its contribution to the scheme may reduce significantly thus leading to a repeat of the problem that plagued the old scheme. It is therefore recommended (based on how it worked in Chile) that contribution should be made solely by the employees while the government should be responsible for payments into the Redemption Fund as stipulated by the Pension Reform Act and the Act should be amended accordingly to take care of the above recommendation. Workers' wages should be sufficiently increased to cater for the extra percentage of contribution (i.e. extra 7.5per cent) that will come from them based on the above recommendation.

(b) Based on the Chilean experience, the laws governing the pension reform scheme in Nigeria should not be rigid. The laws should be open for amendments that will strengthen the operation and management of the pension funds for higher rate of returns and for overall economic growth and development of the country.

(c) In order to significantly increase the coverage of the pension reform scheme and enhance the welfare of the aged, government should ensure that all categories of workers, including self-employed workers and those employed in business organizations with less than 5 employees, adequately take to the scheme. This would help in cushioning the adverse effects of old age for all workers since, we do not have social welfare scheme that covers all in the country as at now.

(d) The implementation and monitoring methods of the National Pension Commission and the Pension Fund Administrators should be made to optimally embrace information and communication technology. This will enhance communication and guarantee efficiency in the services render to workers and in the monitoring and evaluation efforts of these agencies.

(e) There is need for adequate and continuous education of all stakeholders on the objectives, participation, operations, monitoring, offences and related penalties, and rights and benefits of workers. This will

improve the coverage of the scheme and it will help to check unwholesome practices by various stakeholders of the scheme and hence lead to the overall success of the scheme.

## 8. CONCLUSION

A major innovation in Nigeria in recent times, in the country's effort to enthrone rapid and sustainable development, is the adoption and implementation of the 2004 Pension Reform Scheme which is a fully-funded pension system, similar in many respects to the one adopted and implemented in Chile since 1981. The pension reform scheme was set up in order to address the various problems that plagued the various pension schemes that existed before it.

The new pension scheme has many prospects and challenges but the prospects apparently outweigh the challenges. Therefore, efforts should be made by all stakeholders to maximize the prospects and minimize the challenges of the scheme. Suffice it to say that the pension reform scheme has the capacity to impact positively and tremendously on the Nigerian economy, and contribute immensely towards rapid and sustainable growth and reduction in poverty and inequality in the country.

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